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Internal Revenue Service
memorandum

CC:TL:TS/ WHEARD
TL-N-7195-88

date: SEP 15 1988

to: Director, Office of Coordinated Examinations EX:C

from: Director, Tax Litigation Division CC:TL

subject: Request for Technical Advice: Effect of Material Participation
Rules under 469 on TEFRA Partnership/S Corporation

This is in response to your request for technical advice
dated June 16, 1988.

ISSUES

Whether, under I.R.C. § 469 a partner's or shareholder's material or active participation is a (1) partnership item; (2) an affected item; or (3) a non-TEFRA item to be determined at the partner/shareholder examination level.

CONCLUSION

The determinations of material or active participation are affected items subject to deficiency procedures allowed by section 6230 since these issues depend on facts which must be determined at the partner level in order to characterize the partnership items of a partner as passive or nonpassive.

We note, however, that other factors determining the passive or nonpassive character of losses under section 469, such as whether an activity constitutes a trade or business or rental activity, are partnership items since they are determinable at the partnership level and can be applied uniformly with respect to all partners.

We understand regulations will be issued which reflect the above conclusions. See Memorandum attached.

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DISCUSSION

Section 469(a) provides for a limit on the amount of losses and credits that can be used from a "passive activity."

Section 469(c) provides in part as follows:

(c) Passive Activity Defined.- For purposes of this section-

(1) **In general.**- The term "passive activity" means any activity-

(A) which involves the conduct of a trade or business, and

(B) in which the taxpayer does not materially participate. (emphasis supplied)

(2) **Passive activity includes any rental activity.**-The term "passive activity" includes any rental activity.

(3) . . . [etc.]

With respect to material participation, section 469(h) provides:

(h) Material Participation Defined.- For purposes of this section-

(1) **In general.**- A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is -

(A) regular

(B) continuous, and

(C) substantial.

(2) **Interest in Limited Partnerships.**- Except as provided in the regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.

(3) **Treatment of certain retired individuals and surviving spouses.**- A taxpayer shall be treated as materially participating in any farming activity for a taxable year if

paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year.

. . . [etc.]

Section 469(i)(1) provides that section 469(a) does not apply to that portion of the passive activity loss or the "deduction equivalent" of the passive activity credit which is attributable to an individual's rental real estate activities if the individual actively participates in the activity for the taxable year. "Active participation" in a rental activity is not presently defined in the code or regulations but according to the legislative history requires "participat[ion], e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and bona fide sense". Senate Finance Committee Report on H.R. 3838, 99th Cong., 2d Sess, reprinted in Standard Fed. Tax. Report Vol. 73 No. 25 (1986) (hereinafter "Senate Report") at 737.

CHARACTERIZATION OF MATERIAL OR ACTIVE PARTICIPATION
AS PARTNERSHIP OR AFFECTED ITEM

Section 6231(a)(3) defines the term "partnership item" as

any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for the purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

Items which are more appropriately determined at the partnership level under Treas. Reg. § 301.6231(a)(3)-1 include:

(1) The partnership aggregate and each partner's share of each of the following:

(i) Items of income, gain, loss, deduction, or credit of the partnership;

(ii) Expenditures by the partnership not deductible in computing its taxable income (for example, charitable contributions);

(iii) Items of the partnership which may be tax preference items under section 57(a) for any partner;

(iv) Income of the partnership exempt from tax;

(v) partnership liabilities (including determinations with respect to the amount of the liabilities, whether the liabilities are nonrecourse, and changes from the preceding taxable year); and

(vi) Other amounts . . . [etc.]

Thus, the amount of these items generated from a passive or nonpassive activity will be determined at the partnership level. The characterization of these items as passive or nonpassive with respect to each partner, however, based on a taxpayer's material or active participation, is more appropriately determined at the individual taxpayer level.

The facts necessary to determine material or active participation are unique to each taxpayer and depend on the extent and nature of the taxpayer's personal involvement in a partnership activity rather than on determinations common to all partners. See Temp. Treas. Reg. § 301.469-5T; Senate Report at 730-737.

The Senate Report states that the nature and extent of "the individual's involvement" in the operations of an activity must be examined. For instance, in the case of a general partnership engaged in the business of producing movies

[a]n individual [partner] must make a significant contribution [to activities such as] writing screenplays; reading and selecting screenplays; actively negotiating with third parties regarding financing and distribution; and actively supervising production (e.g., selecting and negotiating for the purchase or use of sets, costumes, etcetera). Senate Report at 732.

The above examination of an individual's activities is reflected in a facts and circumstance test in the regulations. Alternatively, the regulations provide for 4 quantitative tests with respect to the participation of an individual taxpayer and 2 tests based on prior participation. In addition, under section

301.469-5T(f) the participation of a partner's spouse is considered in determining a partner's material participation.

Since the amount of income or deduction will be determined at the partnership level in the first instance but the characterization of these items as passive or nonpassive will be determined by partner level determinations of material or active participation, material and active participation will be "affected items." I.R.C. § 6231(a)(5) ("The term "affected item" means any item to the extent such item is affected by a partnership item.)


The present regulations do not specifically provide for the determination of material or active participation as affected items. The Legislation and Regulation Division has informed us, however, that material and active participation will be defined in future regulations as affected items.

As a cautionary note, other factors which determine whether an activity is passive or not may be determined at the partnership level. For instance, whether the "activity" constitutes a trade or business or is a "rental activity" under section 469 will be defined under future regulations as partnership items. See Memorandum attached.

Please refer any questions you may have to Bill Heard at FTS 566-3289.

MARLENE GROSS

By:


R. ALAN LOCKYEAR
Senior Technician Reviewer
Tax Shelter Branch

Attached:

Memorandum addressing which section 469 issues will be partnership items and which will be affected items.

cc: Bob Shaw CC:LR
Stewart Wessler

Internal Revenue Service memorandum

date: AUG 23 1988

to: Robert E. Shaw CC:LR:Brl

from: Michael J. Grace CC:LR:Br3 *mpg*

subject: Section 6231 regulations: Coordination with LR-126-86, 48-87, 125-86, 109-87, and 124-86

This memorandum follows up our conversation in which you requested a list of items that we should treat as partnership items (within the meaning of section 6231 (a) (3)) under the passive loss, interest allocation, and real estate at-risk rules. The list is arranged by regulation projects for which I am responsible.

LR-126-86: Limitations on passive activity losses and credits

Add the following items to § 301.6231 (a) (3)-1 (a) (1), relating to the partnership aggregate and each partner's share of certain items:

1. Items of income, gain, loss, deduction, and credit from--
 - a. Trade or business activities (within the meaning of § 1.469-1T (e) (2)) held through the partnership.
 - b. Rental activities (within the meaning of § 1.469-1T (e) (3)) held through the partnership.¹
 - c. Each oil or gas well drilled or operated pursuant to a working interest (within the meaning of § 1.469-1T (e) (4) (iv)) held through the partnership.
 - d. An activity of trading personal property for the account of owners of interests in the activity

¹ Items 1.a. and 1.b. would include, for example, interest expense allocated under § 1.163-8T to expenditures in connection with an activity.

(within the meaning of § 1.469-1T (e) (6)) held through the partnership.

2. Gain or loss from the disposition of property used by the partnership in an activity.²
3. Portfolio income (within the meaning of § 1.469-2T (c) (3)).
4. The net positive section 481 adjustment (within the meaning of § 1.469-2T (c) (5) (ii) (A)) or the net negative section 481 adjustment (within the meaning of § 1.469-2T (d) (7) (ii) (A)) allocated to each activity held through the partnership.³
5. Gross income from any oil or gas property (within the meaning of § 1.469-2T (c) (6)) in which the partnership holds a working interest.
6. Gross income from a qualified low-income housing project (within the meaning of section 502 of the Tax Reform Act of 1986) operated by the partnership.⁴
7. Gross income from a refund of state, local, or foreign income tax.
8. Gross income that is or may be treated as not from a passive activity under any provision of the regulations under section 469, including but not limited to § 1.469-2T (f) (relating to recharacterized passive income).
9. Deductions that are not passive activity deductions (within the meaning of § 1.469-2T (d)).⁵

² These amounts would not always be included in items 1.a. and 1.b. because in this context "activity" has a generic meaning. In other words, it is not limited to trade or business activities and rental activities but could also include property used in investment activities.

³ See note 2 supra.

⁴ This will only be relevant during the "relief period" (as defined in section 502 (b) of the Tax Reform Act of 1986) with respect to such a project. The last year in any such relief period cannot be after 1993.

⁵ Deductions that are not passive activity deductions are listed in § 1.469-2T (d) (2).

10. Deductions for expenses (other than interest expense) that are clearly and directly allocable (within the meaning of § 1.469-2T (d) (4)) to portfolio income (within the meaning of § 1.469-2T (c) (3)).
11. Interest expense properly allocable to portfolio expenditures (within the meaning of § 1.163-8T (b) (6)).
12. Gain or loss from a disposition of an interest in the partnership allocated to each activity held through the partnership.⁶
13. Credits subject to section 469 for the taxable year (within the meaning of § 1.469-3T (b)).
14. Items of income, gain, loss, deduction, and credit from pre-enactment activities (within the meaning of § 1.469-11T (c) (3)) held through the partnership.⁷

The following items should be added at the end of § 301.6231 (a) (3)-1 (a):

15. Payments described in section 736 (a) (2) for unrealized receivables and goodwill and the activity or activities to which such payments are attributable.⁸
16. Payments described in section 736 (b) and the activity or activities to which such payments are attributable.⁹
17. In the case of credits being taken on a qualified progress expenditure basis, the activity in which the property will be placed in service upon the completion of the expenditures.¹⁰

⁶ See note 2 supra.

⁷ These amounts would be included in items 1.a. and 1.b. but must be separately identified in order for the partner to apply the passive loss phase-in rules from 1987 through 1990.

⁸ See § 1.469-2T (e) (2) (ii) (B).

⁹ See § 1.469-2T (e) (2) (iii).

¹⁰ See § 1.469-3T (b) (2).

Consider adding the following to the list in § 301.6231 (a) (3)-1 (b) of factors that affect the determination of partnership items: "whether an activity held through the partnership is a trade or business activity (within the meaning of § 1.469-1T (e) (2)) or a rental activity (within the meaning of § 1.469-1T (e) (3))".

We do not want "material participation" (within the meaning of § 1.469-5T) or "activity" (within the meaning of § 1.469-4T) to be partnership items.

LR-125-86: Allocation of interest expense among expenditures, and LR-109-87: Special rules for allocation of interest expense among expenditures in the case of passthrough entities

The determinations required under these rules appear to be subsumed under the foregoing list for LR-126-86.

LR-124-86: Extension of at-risk limitations to real property

The partnership must determine whether an activity is an activity of holding real property, whether financing is secured by real property used in such an activity, and whether financing satisfies the requirements for qualified nonrecourse financing (treating the partnership as the borrower). In addition, the partnership must determine each partner's share of financing that is qualified nonrecourse financing with respect to the partnership. All of these determinations appear to be covered by § 301.6231 (a) (3)-1 (a) (1) (vi) (C) ("amounts at risk in any activity to which section 465 applies").

Please let me know if you have any questions about these recommendations.